No. 22,227

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

HULET P. SMITH and LOMA M. SMITH,

Respondents

ON PETITION FOR REVIEW OF THE DECISION OF THE

TAX COURT OF THE UNITED STATES

REPLY BRIEF FOR THE PETITIONER

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In our opening brief, we made two independent arguments. We argued, first, that the taxpayers are not entitled to deduct either maintenance and repair expenses or depreciation allowances on their old house, after they had changed residences and held the old house for sale, because the transaction was a personal transaction which did not convert the old house to income-producing purposes within the meaning of Section 212(2) or Section 167(a)(2) of the 1954 Code. (Br. 5-7, 9-23.) Second, we argued, alternatively, that even if the taxpayers' former residence was held for the production of income, allowance of depreciation deductions would be improper because the property was held only for sale. (Br. 7-8, 22-29.)

While taxpayers appear (Br. 30-37) to deal separately with our depreciation argument, a large portion of their brief is devoted to rebutting the rationale of our depreciation argument (Br. 23-29) as though we had applied it to the maintenance expense issue. We have not. Our position on the maintenance expense issue is simply that if property is held for bona fide investment purposes--whether that purpose be to obtain a current yield (e.g., rent) from the property or only to obtain an anticipated gain or profit from the ultimate sale of that property--the deduction is allowable. We contend that the taxpayers here are not entitled to the maintenance expense deduction only because they did not prove a bona fide conversion of their house from personal purposes to an investment purpose.

1. The taxpayers state that the Tax Court concluded that they did not hold their house for any (Br. 9) "'personal, living or family'" use. The quotes are taxpayers' own. Nowhere in its findings or opinion does the Tax Court use such language or otherwise attempt to analyze or come to grips with the distinction between expenses which are personal, on the one hand, and those which are business or investment, on the other. As the Tax Court opinion shows (R. 24-25) and as we pointed out (Br. 13-14), the Tax Court treated this case (mistakenly) as if the issue were identical to that involved in Mitchell v. Commissioner, 47 T.C. 120 (1966). Mitchell, however, involved an abandoned hospital, not an individual's personal residence, which was acquired and held solely for investment purposes. Had the Tax Court taken into account the personal aspects of the transaction involved in this case--the fact that an individual's personal residence

is a personal asset until converted to some other purpose and the fact that the house in this case was held for sale as a consequence of the ordinary personal transaction of changing taxpayers' residence--had the Tax Court focused on those factors, we believe that the result in this case would have been different.[1/]

2. Indeed, the result was different when the Tax Court considered the same issue subsequently in the reported court-reviewed decision in Wilson v. Commissioner, 49 T.C. 406, 407-410, 414-415 (1968). In that case the taxpayers incurred expenses in maintaining their house during the period it was held for sale. Those taxpayers, like these, were able to sell their old house only sometime after they had moved out of it and into their new house. In that case the Tax Court held that the expenses were not incurred in connection with property held for the production of income and disallowed the deductions. In this case, the result should be the same: the deductions should be disallowed.[2/]

1/ Despite taxpayers' attempt throughout their brief to insulate the Tax Court decision from review, this Court is free to undo mistakes of law and clearly erroneous factual findings. The reliance by the taxpayers (Br. 10, 16-17) on the Dobson rule to restrict review is curious in view of the fact that Congress overturned that rule years ago. Internal Revenue Code of 1954, Section 7482(a); see also Federal Rules of Civil Procedure, Rule 52(a). Moreover, this Court has taken the position that when the primary facts are not in dispute (as in this case with respect to the fact of taxpayers' move and the placement of their house on the market) that this Court may draw its own inferences from such facts. McGah v. Commissioner, 210 F. 2d 769 (C. A. 9th, 1954); Wener v. Commissioner, 242 F. 2d 938 (C. A. 9th, 1957).

2/ The position of the full Tax Court on the issue involved in this case has been set forth in the reported Wilson decision. Accordingly, the taxpayers cannot seriously contend that five or possibly six judges of the Tax Court (Br. 18-21) agree with their position or that the weight of case authority (Br. 4) supports their position.

3. The taxpayers refuse to admit that tax treatment differs depending upon whether property is held for a bona fide investment or profit motive or is, instead, simply a personal asset no longer desired for personal use which taxpayers may wish to dispose of. Thus, they argue (Br. 4) that the legislative history of the present Section 212 shows that maintenance expenses can be deducted whenever the income realized on the sale of property would be taxable. In our view, that statute was intended to apply only to property held for a bona fide profit motive. *Yanow* v. *Commissioner*, 44 T.C. 444 (1965), affirmed, 358 F. 2d 743 (C. A. 3d, 1966).[3/] It was not intended to allow expense deductions in connection with the casual sale of personal asset such as a taxpayer's personal car, his pleasure boat (*May* v. *Commission* 299 F. 2d 725 (C. A. 4th, 1962)), his airplane (*Limerick* v. *Commissione* decided June 8, 1950 (P-H Memo T.C., par. 50,144)), or, as we contend here, his former residence. The taxpayer also relies (Br. 12-14, 25) on the allowance of deductions for expenses incurred to minimize a loss in connection with defaulted bonds. The taxpayers, however, ignore the obvious point that bonds are *investment* property, acquired at the outset with the expectation of gain. That expectations are

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3/ The taxpayers rely (Br. 13) on *Doggett* v. *Burnett*, 65 F. 2d 191 (C.A.D.C., 1933) for the proposition that there "need not be any contemplation of a profit." In fact, that case is to the contrary. The court there held that a profit motive is essential for an activity to be characterized as a business. But, it added, the expectation of a profit need not be objective, it may be subjective (p. 194): "The proper test is not the reasonableness of the taxpayer's belief that a profit will be realized, but whether it is entered into and carried on in good faith and for the purpose of making a profit, or in the belief that a profit can be realized * * * ."

disappointed and the bonds turn out to be unprofitable does not change the nature of the property from investment to personal to disallow the taxpayer a tax benefit for expenses incurred in this investment context. Here, on the other hand, the property (taxpayers' old house) was acquired and held in a personal rather than in an investment context. They acquired and held the house for personal reasons--as a residence. That they tried but were unable to sell it until after they had moved out does not change the house to investment property. If they had been successful in selling it when they wanted to, while they still occupied the house, the house would have been a personal asset and they clearly could not have deducted maintenance expenses. That they were unsuccessful and able to sell it only after they had moved out does not change the house to investment property. Finally, unlike the bond example where the loss sought to be minimized by the taxpayer would be deductible--either as a capital or as an ordinary loss depending upon the facts--the loss here would be a non-deductible personal loss, as the taxpayers admit (Br. 34) and as this Court and other courts have uniformly held (Commissioner's Br. 16-17).

4. Throughout their brief (Br. 1, 11-14, 15, 18, 26-27) the taxpayers mischaracterize our position to be that property must be held for rental rather than for sale for it to qualify as property held for the production of income (investment property) within the meaning of Section 212(2). Our position is that the taxpayers may not deduct expenses or take depreciation with respect to a personal

asset unless they show that it has been converted or dedicated to a profit-making or investment purpose. Once property is held for an investment purpose--which may include a holding either to obtain current yield (e.g., rent) or to realize anticipated gain or profit on disposition--the property may be held for the production of income within the meaning of Section 212(2). Here, however, there was no holding for either purpose. The taxpayers were simply attempting to dispose of their former residence, a personal asset. That they happened to move out of it--again for personal reasons--before the sale actually took place cannot change the nature of the property to investment property.

The taxpayers contend that they should be able to obtain deductions not available to homeowners generally because they are in a different economic position. They contend that the taxpayer who is able to sell his old house before he moves into his new house "is relieved of the expense and does not suffer the depreciation that the taxpayers in the case at bar sustained." (Br. 30, see also Br. 28.) Precisely the opposite is true. The timing of the move has no relevance to whether deductible expenses are incurred. The homeowner who sells his house before he moves into a new house may have incurred expenses in connection with the old house to put it into shape or to maintain it; he may have to incur the expense of temporar lodging quarters; he may find it necessary to incur expenses to maintain the new house before he can move into it.

5. In connection with our alternative depreciation argument, the taxpayer mentions (Br. 31) the Commissioner's acquiescence in Mitchell v. Commissioner, 47 T.C. 120 (1966). We also mentioned the acquiescence (Br. 29, fn. 11) and stated that Mitchell was in conflict with our position here respecting the depreciation deduction (Br. 28). Upon further examination, however, we have concluded that neither Mitchell nor the acquiescence are inconsistent with our position in this case. The crucial fact is that Mitchell did not allow depreciation on property held, as in this case, solely for sale. The taxpayer in Mitchell held the property in the hope of profitable sale, but he also explored the possibilities of converting the property (an abandoned hospital) to a motor hotel, an old age home, and also into offices for doctors a home for nurses. (47 T.C., pp. 123-124.) Accordingly, although we disagree with the rationale of the Tax Court in that case (47 T.C., pp. 128-129), we believe that on the facts of that case the result reached--allowing depreciation deductions--was correct. Because an acquiescence by the Commissioner is limited to the result reached, that acquiescence is not inconsistent with the position we are urging in this case.[4/]

4/ See, e.g., 1966-2 Cum. Bull. 3, where the meaning of an acquiescence is explained as follows:

> Actions of acquiescences in adverse decisions should be relied on by Revenue officers and others concerned as conclusions of the Service only to the application of the law to the facts in the particular case. * * * Acquiescence in a decision means acceptance by the Service of the conclusion reached, and does not necessarily mean acceptance and approval of any or all of the reasons assigned by the Court for its conclusions.

In our main brief we argued that even if the taxpayers' former residence is considered to be held for the production of income for the purpose of Section 212(2), allowance of depreciation deductions would be improper because that property was held only for sale. Whether or not that rationale should be held to apply to any and all property used in a trade or business or for the production of income--a question that need not be decided by this Court--we submit that it should certainly apply in the case of a former residence which is held exclusively for sale. Taxpayers admit (Br. 34) that their old residence does not come within Section 165(c) and that they could not, therefore, deduct a loss incurred on the sale of the house. From this, they argue that it would be unfair to disallow them depreciation deductions. On the contrary, since they admittedly may not obtain tax recognition of the decline in value of their asset _directly_--i.e., through a loss deduction--they should not be allowed to obtain such recognition _indirectly_--i.e., through depreciation deductions. 5/

Respectfully submitted,

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April, 1968.

5/ A depreciation allowance functions as though a "gradual sale" of the asset at a loss were taking place each year it is being used up--to the extent that depreciation is taken as a tax deduction, the cost or other basis of the property is reduced. _United States_ v.
(continued)

CERTIFICATE

I certify that, in connection with the preparation of the brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: ______ day of April, 1968.

____
Attorney

5/ (continued)
Ludey, 274 U.S. 295, 301 (1927). A depreciation allowance thus permits a taxpayer to recover his capital investment in property tax-free. Massey Motors v. United States, 364 U.S. 92, 96 (1960). Cf. Sections 165 and 263. Depreciation is to be distinguished from expenses deductible pursuant to Sections 162(a) and 212. The former represents a decline in the value of assets while the latter, incurred to produce income, do not represent a diminution of the value of the assets resulting in a reduction of their cost basis.